

REPORT OF EXAMINATION
OF
NORCAL MUTUAL INSURANCE COMPANY
AS OF
DECEMBER 31, 2004

Participating State
and Zone:

California

Filed: January 4, 2006

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San Francisco, California
October 25, 2005

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable John Morrison
Secretary, Zone IV-Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of

NORCAL MUTUAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 560 Davis Street, Second Floor, San Francisco, California 94111.

SCOPE OF EXAMINATION

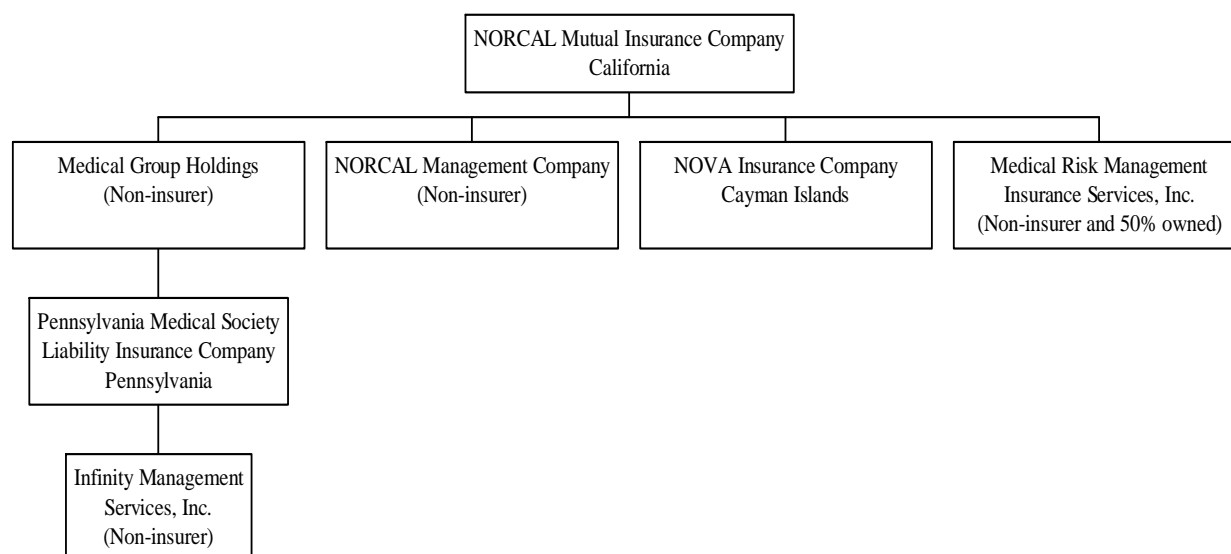
The examination was conducted by the California Department of Insurance pursuant to the National Association of Insurance Commissioners' plan of examination. The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2004.

The present examination of the Company included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2004, as deemed

necessary under the circumstances. In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records; and sales and advertising.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system, which includes a Pennsylvania insurer and a Cayman Islands insurer. The following organizational chart depicts the interrelationship of the companies within the holding company system.



Members of the board of directors and principal officers serving at December 31, 2004 were as follows:

Directors

Name and Residence

Principal Business Affiliations

Patricia A. Dailey, M.D.
Hillsborough, California

Physician

Directors (cont.)

<u>Name and Residence</u>	<u>Principal Business Affiliations</u>
Candace L. Dyer, M.D. Warwick, Rhode Island	Physician
Steven S. Fountain, M.D., Chairman Saratoga, California	Director NORCAL Mutual Insurance Company
Robert M. Hayashi, M.D. Los Gatos, California	Physician
David R. Holley, M.D. Carmel, California	Physician
Walter J. MacGinnitie Atlanta, Georgia	Consultant
James R. McFarland, M.D., Vice Chairman La Quinta, California	Director NORCAL Mutual Insurance Company
Harry B. Richardson, Jr., M.D. Santa Rosa, California	Physician
Michael D. Stephens Newport Beach, California	Hospital Administrator Hoag Memorial Hospital Presbyterian
William R. Vetter, M.D. Carmichael, California	Physician

Principal Officers

<u>Name</u>	<u>Title</u>
James Sunseri	President and Chief Executive Officer
Michael L. Pautler	Senior Vice President and Chief Financial Officer
David R. Holley, M.D.	Secretary
Philip R. Hinderberger	Senior Vice President, General Counsel and Assistant Corporate Secretary
Sharon A. Mullen	Vice President and Controller

Pursuant to a Stock Purchase Agreement effective July 1, 1997, the Company purchased 800 shares or 50% of Medical Group Holdings, Inc., (MGH), a Delaware corporation, for \$6,335,000. The remaining 50% was owned by Medical Mutual Liability Insurance Society of Maryland (MMLIS). MGH owned 100% of Mid-Atlantic Medical Insurance Company, which changed its name to Professionals Advocate Insurance Company (ProAd) effective January 1, 1999. ProAd is a Maryland medical malpractice insurer admitted in California. The transaction was approved by the Maryland Insurance Commissioner on April 4, 1997.

During 1998, the Company and MMLIS each contributed \$33.2 million to MGH, in the form of additional shares purchased, and jointly guaranteed a \$30 million note issued by MGH payable to the Pennsylvania Medical Society (the Society). The funds were used to acquire 82.6% of Pennsylvania Medical Society Liability Insurance Company (PMSLIC), with the remaining 17.4% owned by the Society. The transaction was approved by the California Department of Insurance (CDI) on November 2, 1998, as well as the Pennsylvania and Maryland Insurance Departments. Conditions to the sale of PMSLIC by the Society included a Royalty Agreement and Non-Competition Agreement, in which PMSLIC was to pay the Society \$200,000 and \$400,000 annually for a five-year period ending in 2003.

On January 1, 2000, the Company entered into an agreement with Cooperative of American Physicians, Inc. (CAP) to consolidate their wholly-owned insurance agencies into a combined company named Medical Risk Management Insurance Services, Inc. (MRMI). The Company and CAP each own 50% of MRMI.

On December 31, 2000, the Company increased its ownership in MGH from 50 to 100%. In addition, MGH sold its 100% ownership of ProAd to MMLIS. The combined transaction was approved by the CDI on November 22, 2000, and resulted in the Company no longer being affiliated with MMLIS or ProAd. As a result of this transaction, the Company became sole guarantor on the remaining balance of the \$30 million note issued by MGH.

In April 2002, the Company guaranteed an additional promissory note executed by MGH for \$8,005,000 to purchase the remaining 17.4% of PMSLIC.

In 2004, the Company received approval from the California Department of Insurance (CDI) for the issuance of two surplus notes totaling \$25 million. Repayment of principal and interest is subject to CDI approval.

Cost Sharing Agreements

The Company had two cost sharing agreements in effect at the examination date. In the Services Agreement, the Company jointly provides services and facilities in coordination with NORCAL Management Company and Cooperative of American Physicians, Inc. for the benefit of MRMI. The Cost Sharing Agreement provides for sharing of services and facilities between the Company and PMSLIC. The CDI approved both agreements.

Tax Allocation Agreement

The Company had a tax allocation agreement in which it files a consolidated federal income tax return with its affiliated companies. Tax liability among the affiliates is allocated proportionally based on each subsidiary's separate tax return.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2004, the Company was licensed in Alaska, Arizona, California, Connecticut, the District of Columbia, Massachusetts, Nevada, New Jersey, New Mexico, Oregon, Pennsylvania, Rhode Island, and Vermont. Subsequent to December 31, 2004, the Company elected to become an authorized reinsurer in Maryland due to its assumed runoff business from ProAd. Please refer to the Reinsurance Section for more details.

The majority of business is produced directly in California, where the Company is licensed to write fire, marine, plate glass, liability, boiler and machinery, burglary, sprinkler, team and vehicle, automobile, and miscellaneous. In 2004, 88% of \$209 million of direct premiums was

written in California, 9% in Rhode Island and the following states accounted for the remaining 3% of direct premiums written: Alaska, Arizona, New Mexico, and Oregon.

The Company issues professional and premises liability to physicians, medical groups and hospitals on a claims-made basis. Business is written both directly and through brokers. Underwriting procedures are handled and policy files are kept at the home office in San Francisco. Claims procedures are handled at the home office and the district offices in Pasadena, California, Providence, Rhode Island and Anchorage, Alaska.

REINSURANCE

Assumed

The Company assumed reinsurance from its former affiliate, Professionals Advocate Insurance Company (ProAd), under an agreement in which ProAd ceded and the Company assumed 45% of ProAd's direct business. The treaty was terminated effective December 31, 2000 and is currently in run-off with about \$10 million remaining in assumed losses. The Company became an authorized reinsurer in the State of Maryland in 2005. The Company also assumed minor amounts of reinsurance from General Reinsurance Corporation, EMPAQ and the Hawaii Association of Physicians for Indemnification (HAPI).

Ceded

The following is a summary of primary reinsurance treaties in force as of December 31, 2004:

<u>Lines of Business & Type of Agreement</u>	<u>Reinsurers and Participation</u>	<u>Retention</u>	<u>Limits</u>
Excess of Loss/XPL/Clash: <u>Professional Liability</u>	Hannover Re (Ireland) Ltd-60% E & S Re (Ireland) Ltd.- 15% NORCAL -25%*	\$2M per loss each and every loss occurrence plus 25% participation in amounts in excess of \$2 million.	The greater of \$21M xs of \$2 million or 10% of Original Gross Net Earned Premium.

<u>Lines of Business & Type of Agreement</u>	<u>Reinsurers and Participation</u>	<u>Retention</u>	<u>Limits</u>
Excess of Loss: Healthcare System <u>California</u> <u>Hospitals</u>	General Re – 100%	\$2M each claim \$6M annual aggregate	\$15M xs \$2M \$15 M annual aggregate on Primary Healthcare System Liability \$15M xs of \$2M each claim or each accident with \$15M annual aggregate on Following Form Excess Liability

*Originally, Converium Reinsurance (Converium) was a 50% participant on this contract. During 2004, Converium executed a novation with the other reinsurers for 50% of its participation and commuted the remaining 25% back to the Company.

In addition, the Company secures facultative coverage for policies which do not meet the conditions of either of the above treaties.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Underwriting and Investment Exhibit for the Year Ended December 31, 2004

Reconciliation of Surplus as Regards Policyholders from December 31, 2001
through December 31, 2004

Statement of Financial Condition
as of December 31, 2004

<u>Assets</u>	<u>Ledger and Non-ledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 510,104,143	\$	\$ 510,104,143	
Stocks:				
Preferred	8,905,513		8,905,513	
Common	261,737,697		261,737,697	(1)
Cash and short-term investments	46,683,298		46,683,298	
Other invested assets	20,788,469		20,788,469	
Investment income due and accrued	6,102,146		6,102,146	
Premiums and agents' balances:				
In course of collection	240,911	240,911	0	
Booked but deferred and not yet due	18,024,525		18,024,525	
Reinsurance recoverable on loss payments	743,288		743,288	
Federal income tax recoverable	384,001		384,001	
Net deferred tax asset	17,704,289	5,726,045	11,978,244	
Electronic data processing equipment	1,103,586	670,802	432,784	
Furniture and equipment	896,992	896,992	0	
Receivable from parent, subsidiaries and affiliates	81,446		81,446	
Other assets nonadmitted	1,500,816	1,500,816	0	
Aggregate write-ins for other than invested assets	<u>2,215,804</u>	<u>1,543,621</u>	<u>672,182</u>	
Total assets	<u>\$ 897,216,924</u>	<u>\$ 10,579,187</u>	<u>\$ 886,637,737</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 281,512,827	(2)
Reinsurance payable on paid loss and loss adjustment expenses			491,851	
Loss adjustment expenses			188,941,941	(2)
Commissions payable, contingent commissions and other similar charges			1,185,858	
Other expenses			8,255,892	
Unearned premiums			40,760,582	
Advance premiums			32,560,568	
Ceded reinsurance premiums payable			1,064,951	
Funds held by the Company under reinsurance treaties			8,332,872	
Amounts withheld or retained by company for account of others			10,824,837	
Provision for reinsurance			11,193	
Payable for securities			612,132	
Aggregate write-ins for liabilities			<u>456,204</u>	
Total liabilities			575,011,708	
Surplus notes		\$ 25,000,000		
Unassigned funds (surplus)		<u>286,626,029</u>		
Surplus as regards policyholders			<u>311,626,029</u>	
Total liabilities, surplus and other funds			<u>\$ 886,637,737</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2004

Statement of Income

Underwriting Income

Premiums earned		\$198,712,173
Deductions:		
Losses incurred	\$91,600,718	
Loss expenses incurred	95,195,776	
Other underwriting expenses incurred	<u>30,597,733</u>	
Total underwriting deductions		<u>217,394,227</u>
Net underwriting loss		(18,682,054)

Investment Income

Net investment income earned	\$23,953,916	
Net realized capital gains	<u>13,815,579</u>	
Net investment gain		37,769,495

Other Income

Aggregate write-ins for miscellaneous income	<u>\$(1,891,563)</u>	
Total other income		<u>(1,891,563)</u>
Net income before dividends to policyholders and before federal income taxes		17,195,878
Dividends to policyholders		(14,595)
Federal income taxes incurred		<u>187,552</u>
Net income		<u>\$17,022,921</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2003		\$256,279,640
Net income	\$17,022,921	
Change in net unrealized capital gain	15,240,549	
Change in net deferred income tax	(6,762,330)	
Change in nonadmitted assets	3,550,274	
Change in provision for reinsurance	1,294,975	
Change in surplus notes	<u>25,000,000</u>	
Change in surplus as regards policyholders		<u>55,346,389</u>
Surplus as regards policyholders, December 31, 2004		<u>\$311,626,029</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2004

Surplus as regards policyholders, December 31, 2001, per Examination	\$222,799,181
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	Gain in Surplus	Loss in Surplus
Net income	\$ 41,007,513	\$
Change in net unrealized capital gains	19,615,335	
Change in nonadmitted assets	3,490,127	
Change in net deferred income tax		274,934
Change in provision for reinsurance		11,193
Change in surplus notes	25,000,000	
Total gains in surplus	\$ 89,112,975	\$ 286,127

Net increase in surplus as regards policyholders	<u>88,826,848</u>
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Surplus as regards policyholders, December 31, 2004, per Examination	<u>\$311,626,029</u>
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COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Common Stock

The Company was not in compliance with the National Association of Insurance Commissioners Practices and Procedures of the Securities Valuation Office Manual, Part 8, because it did not annually update its filings of its subsidiary investments. During the course of the examination, the Company provided flings for the current year and intends to comply going forward.

(2) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI), pursuant to California Insurance Code (CIC) Section 733(g), retained an independent actuary for the purpose of providing a full actuarial evaluation of the Company's loss and loss adjustment expense reserves as of December 31, 2004. Based on the evaluation and the review of the work by a Casualty Actuary from the CDI, the Company's December 31, 2004 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Comments on Financial Statement Items (Page 13): It was recommended the Company revise its DD&R reserving methodology by using discount, loss trend and experience modification factors

that better match current market, duration and loss trend data. The Company has revised its DD&R reserving methodology in accordance with the recommendation.

ACKNOWLEDGEMENT

The undersigned would like to sincerely thank the Company's officers and employees for their cooperation and assistance during the course of this examination.

Respectfully Submitted,

/S/

Susan Bernard, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California